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IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

JOHN W. BANKS, *Respondent*.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

SIGITAS J. BANAITIS, *Respondent*.

On Writs Of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

AMICUS CURIAE BRIEF OF THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA IN SUPPORT OF RESPONDENTS

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AMICUS CURIAE BRIEF OF THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA IN SUPPORT OF RESPONDENTS

IDENTITY AND INTEREST OF *AMICUS CURIAE*

The Association of Trial Lawyers of America ["ATLA"] respectfully submits this brief as *amicus curiae*. The parties have filed letters of consent to the filing of this amicus brief with this Court.[1]

ATLA is a voluntary national bar association whose approximately 50,000 trial lawyer members primarily represent individual plaintiffs in civil actions.

[1] Pursuant to Rule 37.6, Amicus discloses that no counsel for a party authored any part of this brief, nor did any person or entity other than Amicus Curiae, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

ATLA is concerned that the tax treatment of attorney fees proposed by the Commissioner will result in unfair and excessive taxation of plaintiffs in nonphysical personal injury cases and will undermine the enforcement through private civil lawsuits of important personal rights guaranteed under both state and federal law.

SUMMARY OF THE ARGUMENT

1. The Commissioner asks this Court to approve the IRS treatment of attorney fees that are incurred by plaintiffs who receive damages in nonphysical personal injury cases. The Commissioner asserts that legal fees must be included in gross income and deducted as miscellaneous itemized deductions. Although a number of lower courts have agreed with the Commissioner, this include-deduct method results in unfair taxation and undermines substantive state and federal law.

Miscellaneous itemized deductions are not fully deductible, and, where the alternative minimum tax is triggered, are not deductible at all. As a result, plaintiffs are taxed on amounts they did not receive and over which they had no dominion or control. Although the cases before the Court involve contingency fees, the IRS has applied this treatment to court-awarded fees under fee-shifting statutes, which permit fees in excess of monetary awards. In some cases, a victim of discrimination who "won" in court has owed more in taxes than the net recovery.

This draconian result is not only unfair to the affected taxpayers; it also undermines the purposes of state and federal laws protecting personal rights. The prospect of excessive tax liability, even to the point of exceeding any recovery, is a powerful disincentive to seeking vindication of rights in court.

It undermines the legitimate interests of the States in enforcing their own tort laws, a result Congress did not intend. And it undermines the intent of Congress to rely on private lawsuits to eradicate discrimination and to assure legal representation to the victims of discrimination by authorizing court-awarded attorney fees.

The include-deduct method also undermines congressional purpose by making good faith settlement of such claims more complicated and expensive for plaintiffs and defendants alike.

2. The Commissioner does not base the include-deduct treatment of attorney fees on specific Code provisions, but on an interpretation of judge-made doctrines. It is clear that the assignment of income doctrine does not apply to contingency fee agreements. The doctrine preserves the graduated structure of the income tax by barring an assignment of income by the person who earned it to a lower bracket donee. It does not result in allocating the income to both.

Most importantly, the doctrine applies to taxpayers who retain an income-producing asset while redirecting the stream of income produced. In this case, the taxpayers' causes of action are not income-producing. They relinquished their claims entirely in exchange for money. The appropriate tax rules are those governing the disposition of property.

Nor is the payment of fees a repayment of a debt owed by the client to the attorney. Under a contingency fee agreement, no pre-existing debt exists. Moreover, court-awarded fees satisfy a debt owed by the defendant, not the client.

The include-deduct method is not required to avoid a tax incentive favoring contingency fee arrangements over hourly-rate payment. For compelling non-tax reasons, few individuals pay attorneys by the hour to pursue nonphysical personal injury claims. Plaintiffs cannot afford such hourly fees, as Congress itself recognized. Contingency fees also shift the risk of loss to the attorney, and align the attorney's interest with that of the client.

3. Damages received on account of personal injury constitute the proceeds of disposition of property. An unliquidated cause of action is a species of property. Under the Code, it is "intangible personal property" which can be bought, sold or assigned. In fact, taxpayer Banks in this case purchased his cause of action. A cause of action also qualifies as a capital asset under the Code. The taxpayer's release or relinquishment of a cause of action in exchange for a monetary award or settlement comes within the broad definition of a "disposition" of property. The proper treatment of legal fees is as a capital expense, subtracted from the proceeds of the settlement or award, not as a deduction.

This capitalization of legal fees does not offend the "origin of the claim" test, which governs deductions from income for legal fees related to income-producing assets. The test does not address the antecedent question of whether taxpayer has income in the first place. The test does not apply to the disposition of property, where the general rule is that legal fees are a capital expense. Subtracting attorney fees to arrive at gross income does not lead to lead to conversion of that income from ordinary to capital gain.

ARGUMENT

I. TAXATION OF ATTORNEY FEES AS INCOME TO CLIENTS IS UNFAIR AND UNDERMINES THE PURPOSES OF STATE AND FEDERAL LAWS.

A. Treatment of Attorney Fees Income To Both Client and Attorney Results in Unfair Double Taxation of Damages Received on Account of Nonphysical Injury.

Taxpayer Sigitas Banaitis, a bank vice president, brought suit against the bank and its new owner, alleging wrongful discharge, interfering with his employment agreement, and punishing him for refusing to disclose confidential information of the bank's customers. An Oregon state court jury agreed and awarded Banaitis compensatory and punitive damages. The court of appeals upheld the jury's verdict. *Banaitis v. Mitsubishi Bank, Ltd.*, 129 Or. App. 371, 879 P.2d 1288 (1994). The parties reached a settlement totaling $8,728,599. Of that amount, $3,864,012 was paid directly to Banaitis's attorneys, pursuant to their contingency fee agreement with Banaitis. *Banaitis v. Commissioner,* 340 F.3d 1074, 1077-78 (9th Cir. 2003).

Taxpayer John W. Banks, brought suit against his former employer, the California Department of Education, alleging he was fired in violation of Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983. During the trial, the parties settled. DOE paid $464,000 to Banks, who paid $150,000 to his attorney pursuant to their contingency fee agreement. *Banks v. Commissioner*, 345 F.3d 373, 375-76 (6th Cir. 2003).

In both instances the Commissioner issued a notice of deficiency, asserting that the taxpayers were required to include the amount paid to their attorneys in gross income. *Banaitis* at 1078; *Banks* at 382. As a result, taxpayers' liability was substantially increased. Their situation is hardly unique.

Prior to the mid-1990's, I.R.C. § 104(a)(2), which excluded from income "damages received . . . on account of personal injuries," was widely viewed as encompassing such nonphysical harms as employment discrimination. *See Commissioner v. Schleier*, 515 U.S. 323, 338-39 (1995) (O'Connor, J., dissenting). Even as this Court set forth a more restrictive reading of that section in *Schleier* and in *United States v. Burke,* 504 U.S. 229 (1992), the Court indicated that taxable damages in such cases excluded attorney fees. In *O'Gilvie v. United States,* 519 U.S. 79 (1996), the Court held that the "net proceeds" of plaintiffs punitive damages claims were not excluded under I.R.C. § 104(a)(2).[2] *See* 6 MERTENS LAW OF FEDERAL INCOME TAXATION § 24A:42.12 (Supp. 2001). *See also id.* at § 24A:42.12 n.24 (citing lower federal court opinions treating punitive damages, net of attorney fees, as taxable income).

Shortly thereafter, Congress amended the Code to exclude only damages received on account of "physical injuries." Small Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996); I.R.C. § 104(a)(2) (1997). As a result, many

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[2] The lower court opinion makes clear that the "net proceeds" were net of attorney fees and expenses. See *O'Gilvie v. United States,* 66 F.3d 1550, 1552 (10th Cir. 1995).

types of tort or tort-like damages involving nonphysical harm under state and federal law were no longer excluded from income.

The IRS quickly took the position that plaintiff's income in such cases should also include fees paid to plaintiff's attorney under a contingent fee agreement. *See* Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997). Such fees, the IRS maintained, should be treated as miscellaneous itemized deductions under I.R.C. § 67(a). The Service has targeted such taxpayers for enforcement attention. *See generally*, Internal Revenue Service, *Market Segment Specialization Program Audit Guide for Lawsuit Awards and Settlements* (Doc. 2001-2574).

Taxpayers would not be significantly harmed if the included attorney fees were fully deductible. But they are not. I.R.C. § 67(a) sets a floor, permitting deductions "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." They are also subject to a phase out when adjusted gross income exceeds the applicable amount – $142,700 ($71,350 for a married individual filing separately) in 2004. I.R.C. §1, Note. The combined effect of these limitations is to increase the taxpayer's effective marginal tax rate significantly. Laura Sager and Stephen Cohen, *How the Income Tax Undermines Civil Rights Law,* 73 So. Cal. L. Rev. 1075, 1085 (2000).

Worse yet, the taxpayer may be denied any deduction at all for legal fees where the Alternative Minimum Tax is triggered. The AMT imposes rates of 26 or 28%, and "[n]o deduction shall be allowed for any miscellaneous itemized deduction." I.R.C. § 56(b)(1)(A)(i) (2000). As one Tax Court judge stated, applying the AMT in this situation "can raise

effective tax rates to hardship levels." *Kenseth v. Commissioner,* 114 T.C. 399, 419 (2000) (Chabot, J., dissenting). In fact, notes Judge Beghe, dissenting in the same case, where total legal fees exceed about 72% of gross recovery, the tax can exceed plaintiff's net recovery. *Id.* at 425-26 n. 17 (Beghe, J., dissenting). *See also* Sager & Cohen, *supra,* at 1076-78.

For example, the taxpayer in *Alexander v. IRS,* 72 F.3d 938, 946-947 (1st Cir.1995), obtained a favorable settlement of her employment discrimination suit. However, legal fees and the high costs of her court battle left her with a net recovery of only $5,000, but a tax bill of $53,900. Sager & Cohen, *supra,* at 1078 & n.15. Similarly, in *Coady v. Commissioner,* 213 F.3d 1187 (9th Cir. 2000), after prevailing in her bench trial on her claim that she was wrongfully discharged, Mrs. Coady was left with a tax liability greater than her net recovery, telling a reporter, "I won the battle, but I lost the war." Brigid McMenamin, "The Lawyers Did Just Fine," Forbes, Apr. 1, 2002, at 80.

Such outcomes prompted the office of the National Taxpayer Advocate, within the IRS, to state that the include-deduct method "deviates from the concept of taxing net income" and does not bring about a fair result for taxpayers in nonphysical personal injury cases. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 166. The Taxpayer Advocate added, "The result would be the same whether the attorney's fee arose from a contingent fee agreement or a court-ordered award." *Id.* at 162.

In fact, the unfairness of the Commissioner's include-deduct theory is even more egregious in such

cases because court-awarded fees may, for good reason, well exceed the monetary award to the plaintiff. *Riverside v. Rivera,* 477 U.S. 561, 574 (1986). Nevertheless, the IRS has applied its theory to court awarded fees under federal fee-shifting statutes

One such case that came to national attention is that of police officer Cynthia Spina. For eight years, she endured a campaign of sexual harassment by her coworkers and superiors. Sexual rumors were spread through her workplace, pornography repeatedly was placed on her desk, her tires were slashed, she was passed over for assignments and promotions, and fellow officers refused to back her up in dangerous situations. *See Spina v. Forest Preserve Dist. of Cook County,* 207 F. Supp. 2d 764 (N.D. Ill. 2002). She prevailed in a hard-fought sex discrimination and harassment lawsuit under Title VII. The damage award was $300,000, and attorney fees and costs totaled almost $1,000,000. *Spina v. Forest Preserve Dist. of Cook County,* No. 98 C 1393 (D. Ill., July 30, 2002) (granting plaintiff's fee petition). Because the IRS required Spina to report the court-awarded fee as income, according to her lawyer,[3] "She loses every penny of the award plus she will end up owing the Internal Revenue Service $99,000." Adam Liptak, "Tax Bill Exceeds Award To Officer in Sex Bias Suit," N.Y. Times, August 11, 2002, at A12. *See also* "Outrageous Injustice," Newsday, Aug. 17, 2002.

The prospect that a "victorious" plaintiff may be required to pay for the privilege may lead some

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[3] Ms. Spina was represented by ATLA member Monica E. McFadden, of Chicago.

Americans to believe that their government has taken back the promise that was wrested from King John in 1215: "To no one will we sell, to no one will we refuse or delay, right or justice." William S. McKechnie, MAGNA CARTA 395 (2d ed. 1914). Many will simply decide that they cannot afford justice.

B. Inclusion of Attorney Fees As Income to Plaintiffs In Nonphysical Personal Injury Cases Undermines the Purpose of Federal and State Laws.

1. Unfair Taxation Hinders States' Ability to Enforce Their Own Subtantive Tort Laws.

The harm caused by Commissioner's include-deduct treatment of attorney fees in personal injury cases is not limited to the unfairness to individual taxpayers like those before this Court. Obviously, the threat that the IRS will take an excessively large bite out of the net recovery is a powerful disincentive to those who may seek to vindicate their rights. Without private enforcement, personal rights protected by state and federal law may become hollow promises.

Few of the reported cases addressing this issue involve plaintiffs like Banaitis, asserting rights under state law.[4] *See e.g., Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001) (wrongful discharge); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000)

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[4] Banaidis's underlying lawsuit was based on state tort rules protecting not only employment relationships, but also the confidentiality of trade information, as the jury's special verdict reflects. See 340 F.3d at 1077.

(defamation). Nevertheless, most tort law is state law. Approval of the Commissioner's tax treatment of fees in nonphysical personal injury cases will affect plaintiffs in a wide variety of state tort actions, such as invasion of privacy, false imprisonment, intentional infliction of emotional distress, and causes of action created by state statute.

The purpose of substantive tort law is not only to make whole the victim, but also to deter misconduct and prevent such harms in the first place. See American Bar Association, TOWARDS A JURISPRUDENCE OF INJURY 4-3 (1984) (deterrence of misconduct is "a strong thread running through tort law"); W. Page Keeton et al., PROSSER AND KEETON ON THE LAW OF TORTS § 4 (5th ed. 1984); Clarence Morris, *Punitive Damages in Tort Cases*, 46 Harv. L. Rev. 1173, 1177 (1931) (both compensatory and punitive damages serve tort law's "admonitory" function of deterring misconduct); Robert D. Cooter, *Economic Analysis of Punitive Damages*, 56 So. Cal. L. Rev. 79, 137 (1982) ("There is now a rich body of academic literature supporting the view that a primary purpose of tort liability rules is to discourage inappropriate behavior.").

"It is beyond dispute," this Court has emphasized, that the States have "a significant interest in redressing injuries that actually occur within the State." *International Paper Co. v. Ouellette*, 479 U.S. 481, 502-503 (1987). Though the supremacy of federal law sweeps broadly, this Court has cautioned that the "State's interest in applying its own tort laws cannot be superseded by a federal act unless that was the clear and manifest purpose of Congress." *Id.* Similarly, in *Farmer v. Carpenters*, 430 U.S. 290 (1977), where the Court held that the

NLRA did not pre-empt a union member's suit against his union for intentional infliction of emotional distress, the Court pointed out that federal law must take into account the legitimate and substantial interest of the State in protecting its citizens through tort liability. *Id.* at 304.

Keeping in mind that "[t]he power to tax involves the power to destroy." *McCulloch v. Maryland,* 17 U.S. (4 Wheat.) 316, 431 (1819), this Court should reject the Commissioner's invitation to adopt a tax treatment of state tort damages that undermines a State's ability to enforce its own substantive tort law.

2. Excessive Taxation Undermines the Objectives of Federal Laws

Most reported cases addressing this issue have involved taxpayers who, like Banks, succeeded in vindicating their rights under federal civil rights statutes. Those plaintiffs obtained legal representation under contingency fee agreements under which the attorney would be paid a percentage of any settlement. Frequently, where such cases proceed to trial, a prevailing plaintiff may move for attorney fees under a fee-shifting statute. Taxpayer Banks, for example, could have moved for an award of attorney fees if the parties had not settled and Banks had prevailed in his Title VII claims.

Without question, unlawful discrimination "is a fundamental injury to the individual rights of a person," *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987), that causes grave harm to its victims. *United States v. Burke,* 504 U.S. 229, 238 (1992).

Congress enacted the federal civil rights statutes not only to make those victims whole, but

also with "the central statutory purposes of eradicating discrimination throughout the economy." *Albemarle Paper Co. v. Moody,* 422 U.S. 405, 420-421 (1975); *United States v. Burke,* 504 U.S. 229, 250 (1992) (O'Connor, J., dissenting). Individual lawsuits serve as "the chosen instrument of Congress to vindicate 'a policy that Congress considered of the highest priority.'" *Christiansburg Garment Co. v. EEOC,* 434 U.S. 412, 418 (1978), quoting *Newman v. Piggie Park Enterprises Inc.*, 390 U.S. 400, 402 (1968).

Congress also recognized that if plaintiffs acting as a "private attorney general" were forced to bear their own litigation costs, "few aggrieved parties would be in a position to advance the public interest." *Piggie Park, supra,* at 401-02. "Congress therefore enacted the provision for counsel fees . . . to encourage individuals injured by racial discrimination to seek judicial relief." *Id.*[5] Courts may properly award attorney fees in such cases in excess of the monetary damages awarded to the plaintiff. *Riverside v. Rivera,* 477 U.S. 561, 574 (1986) (upholding award of $245,456 in attorney fees where a jury awarded damages totaling $33,350);

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[5] See, e.g., Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988(b) ("In any action or proceeding to enforce a provision of sections 1981, 1982, 1983, 1985, and 1986 of this title, title IX of Public Law 92-318 . . . , or title VI of the Civil Rights Act of 1964 . . . , the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs."). Congress enacted similar fee-shifting provisions in the Civil Rights Act of 1964, 42 U.S.C. § 2000a-3(b); Civil Rights Acts of 1964, 42 U.S.C. § 2000e-5(k); Americans With Disabilities Act of 1990, 42 U.S.C. § 12205; Fair Housing Act, 42 U.S.C. § 3612(p) (1994); the Voting Rights Act Amendments of 1975, 42 U.S.C. § 1973l (e).

Copeland v. Marshall, 205 U.S. App. D.C. 390, 400-410, 641 F.2d 880, 890-900 (1980) (upholding attorney fees of $160,000 for representing a plaintiff who recovered $30,000).

In the event of settlement, of course, fees are generally allocated by a contingency fee agreement, rather than court award. However, it is the prospect of a substantial fee award that motivates defendants to make settlement offers that will compensate both attorney and client and, ultimately, allow victims of discrimination to obtain competent legal representation. Separate tax treatment of contingency fees and statutory fee awards would therefore be unworkable.[6]

This Court's approval of the Commissioner's include-deduct tax treatment of such fees would have the cruelly ironic result of *discouraging* those with meritorious cases from seeking judicial redress. Few aggrieved persons are likely to pursue their claims if this Court announces that they thereby obligate themselves to report as income an unknown sum of money they will never see and which could leave

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6 The Commissioner states that the rule would apply only in cases involving taxable damage awards. Brief of Petitioner at n.5. However, the Commissioner's arguments are not so limited. If a plaintiff prevails in a case, obtaining important injunctive relief but nominal or no monetary damages, the fee award would appear to have the same status under the Commissioner's application of the assignment of income doctrine or the view that the fee satisfies a debt owed by the client to the attorney. See Edward A. Morse, *Taxing Plaintiffs: A Look At Tax Accounting For Attorney's Fees and Litigation Costs,* 107 Dick. L. Rev. 405, 481 (2003) ("consistency would require extending similar treatment to awards under fee-shifting statutes -- regardless of whether any monetary awards are ultimately collected").

them owing the IRS more than they recover. "This Draconian result," it has rightly been stated, "can only undermine our civil rights laws." *Sinyard v. Commissoner*, 268 F.3d 756, 763 (9th Cir. 2001) (McKeown, J., dissenting).

Moreover, this Court's approval of the Commissioner's position would likely extend such draconian results far beyond employment discrimination cases. Congress has enacted an estimated 150 fee-shifting statutes whose purpose is "to enable private parties to obtain legal help in seeking redress for injuries resulting from the actual or threatened violation of specific federal laws." *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air,* 478 U.S. 546, 565 (1986). Charles Silver, *Unloading The Lodestar: Toward A New Fee Award Procedure,* 70 Tex. L. Rev. 865, 873 (1992) (estimating 150 fee-shifting statutes); *Marek v. Chesny,* 473 U.S. 1, 43-51 (1985) (Appendix to dissenting opinion of Brennan, J., listing fee-shifting statutes).

Many States have also adopted legislation providing court-awarded fees. *See, e.g., Abrams v. Lightolier, Inc.,* 50 F.3d 1204 (3d Cir. 1995) (applying New Jersey fee-shifting statute in connection with employment discrimination claim); *McGinnis v. Kentucky Fried Chicken*, 51 F.3d 805 (9th Cir. 1994) (applying Washington fee-shifting statute in employment discrimination case); *Flannery v. Prentice,* 28 P.3d 860 (Cal. 2001) (attorney fees awarded under California's Fair Employment and Housing Act).

3. The Include-Deduct Tax Treatment of Attorney Fees Unnecessarily Increases the Costs of Settlements.

Congress, of course, did not intend to promote litigation for its own sake. Congress aimed to eliminate discrimination and to make whole its victims. Good faith settlements of meritorious claims further this objective. However, as many trial lawyers can attest, the include-deduct tax treatment of attorney fees introduces additional complexity, uncertainty, and expense into settlement negotiations. Counsel must undertake a thorough review of the tax impact that fees may have on the client and adjust settlement demands upward to avoid an unanticipated and unjust outcome. Defendants, as a result, may expect to face more difficult and expensive settlements. Tax considerations figured into Respondent Banks's settlement negotiations, for example. 345 F.3d at 376.

It may also be expected that courts, recognizing that Congress did not intend to penalize successful civil rights claimants, will endeavor to avoid unfair tax consequences of fee awards. For example, in *Blaney v. International Ass'n of Machinists & Aerospace Workers*, 55 P.3d 1208, 1210 (Wash. Ct. App. 2002), the court awarded plaintiff a supplemental judgment to offset the tax consequences of attorney fees awarded under a state fee-shifting statute. In *Porter v. United States Agency for International Development*, 293 F. Supp.2d 152, 157 (D.D.C. 2003), the district court tentatively declined to "gross up" plaintiff's fee award to offset potential taxes, but fashioned its award "to ensure that the attorneys' fee award never becomes a tax problem for Porter." *Id.* at 157.

II. THE IRS POSITION IS BASED ON AN ERRONEOUS APPLICATION OF THIS COURT'S JUDICIAL DOCTRINES REGARDING INCOME.

A. The Assignment of Income Doctrine Does Not Apply To Attorney Fee Agreements.

How does the Commissioner support a result that even courts that accept it say "smacks of injustice," *Alexander, supra*, 72 F.3d at 946, "unfairness," *Sinyard, supra,* 268 F.3d at 760, and creates "a terror for civil rights plaintiffs." *Jalali v. Root,* 109 Cal. App.4th 1768, 1775, 1 Cal Rptr. 3d 689, 693 (2003)?

Oddly, apart from stressing that I.R.C. § 61(a) includes in gross income "all income from whatever source derived,"[7] the Commissioner does not base the

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[7] The Court's interpretation of this section in *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), relied upon in Brief of Petitioner at 15, is indeed broad, but not unbounded. The Court used a three-prong test for determining gross income, looking to taxpayers' "undeniable accessions to wealth, clearly realized, and over which taxpayers have complete dominion." 348 U.S. at 431. It is difficult to agree that taxpayers in this case either "clearly realized" or had "complete dominion" over the fees retained by their attorneys which taxpayers never saw and never had the right to spend on anything other than attorney fees. Nor did they experience "undeniable accessions to wealth" where neither taxpayers' net worth nor personal consumption were increased by the amount of the fees.

Rather, the fees fall within the basic principle that "that a person's taxable income should not include the cost of producing that income." *Hantzis v. Commissioner*, 638 F.2d 248, 249 (1st Cir. 1981). See also National Taxpayer's Advocate, *supra,* at 166, stating that inclusion of attorney fees "deviates from the concept of taxing net income."

inclusion-deduction treatment of attorney fees in nonphysical injury cases on provisions enacted by Congress in the Code. Indeed, this "anomalous result [was] no doubt unintended" by Congress. *Sinyard, supra,* 268 F.3d at 759. Or, as more memorably phrased by the California Court of Appeal, "Chalk another one up to the law of unintended consequences." *Jalali v. Root*, supra, 109 Cal. App. 4th at 1781, 1 Cal. Rptr. 3d at 698 (2003).

The Commissioner instead relies on an interpretation of judge-made doctrine, which has been referred to as "the Federal common law of taxation as adopted by the Supreme Court." *Kenseth, supra*, 114 T.C. at 432 (Beghe, J., dissenting). Primarily, the Commissioner relies on the "assignment of income" doctrine set forth by this Court in *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst,* 311 U.S. 112 (1940). Brief for the Petitioner at 18-22.

Lucas arranged to have half his salary paid directly to his wife. Horst had the interest earned by his bonds paid directly to his son by detaching and giving the negotiable bond coupons to his son. The Court in both cases held that the salary or bond interest was income to the donor.

The basic principle at work, the Commissioner recognizes, is to ensure that income is taxed to the person who earns it. Brief of Petitioner at 19 & 20. The doctrine serves as a "cornerstone of our graduated income tax system," *United States v. Bayse,* 410 U.S. 441, 450 (1973), by ignoring for tax purposes gratuitous transfers of income from the person who earned it to a lower-bracket donee.

The doctrine simply does not apply to attorney-client fee agreements. It cannot be argued that the attorney who secures a favorable verdict or settlement has not earned his or her fee. Nor does the Commissioner assert that these agreements shift income to a lower bracket taxpayer. Moreover, the issue resolved in *Lucas* and *Horst* was whether the income more properly belongs to the taxpayer *or* the donee. As has been noted, the assignment of income doctrine does not result in attributing the income to both. *See Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

The most crucial distinction, however, is that Lucas and Horst were taxpayers who retained ownership or control over an income-producing asset, while attempting to redirect the stream of income that was produced. Lucas did not give up his job; Horst did not part with his bonds. As the Court in *Horst* stated, "where the donor retains control of the trust property the income is taxable to him although paid to the donee." 311 U.S. at 119.

Much confusion, it appears, comes from the attempts to characterize the contingency agreement as the transfer of the fruits of the client's orchard or some of its trees. *See* Brief of Petitioner at 29. Judge Cardozo has warned that "[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

ATLA suggests that the significant event is not the signing of the contingent fee agreement, which is a nontaxable event. Rather it is the payment of the settlement or judgment. The Commissioner correctly states that "the settlement

proceeds represent the value given in exchange for the dismissal of respondents' claims." Brief of Petitioner at 12.

Unlike Lucas and Horst, the taxpayer's cause of action does not produce income while he retains ownership and control of the asset. Rather, Banks and Banaitis relinquished their claim entirely, agreeing to pay their counsel a percentage of the proceeds. This, ATLA submits, is in the nature of a sale or disposition of property.[8] ATLA argues in Part III, below, that the tax rules applicable to legal fees in connection to such sales or dispositions should apply.

B. Characterizing Attorney Fees as Satisfaction of a Debt Does Not Support Include-Deduct Tax Treatment.

The Commissioner asserts that the "relationship between the client and his attorney is simply that of debtor and creditor." Brief of Petitioner at 13. The payment of attorney fees, the Commissioner reasons, is in satisfaction of that debt, resulting in income to the debtor-taxpayer under *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, 720 (1929). Brief of Petitioner at 19.

ATLA suggests that this approach is not useful here, where there is no pre-existing debt. Under a contingency fee agreement, until the defendant makes payment in exchange for release of the plaintiff's claim, the client owes nothing to the lawyer.

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[8] *Cf. Srivastava v. Commissioner*, 220 F.3d 353, 359 (5th Cir.2000) ("the doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset)

Constructing a debt in these circumstances leads to anomalous results. For example, a client's contingency fee may amount to $10,000. It is not uncommon for a trial lawyer in a case where high expenses and low recovery would leave the client with little compensation, to reduce his or her fee, perhaps in this instance by $1,000. However, forgiveness of indebtedness is also income to the debtor. Under the Commissioner's view, the client would have to report as income $11,000 on an attorney fee of $10,000.

Moreover, the creditor-debtor theory does not address the most egregiously unfair application of the include-deduct tax treatment: Court awarded fees under fee-shifting statutes. Congress enacts such statutes as an exception to the general rule that a party is responsible for his or her own legal fees. *Alyeska Pipeline Services. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975). Payment of fees awarded by the court are in satisfaction of a debt which is debt by the *defendant,* not the client, to the attorney. As Judge McKeown noted in his dissent in *Sinyard, supra*, "the district court taxed attorney's fees against IDS. When IDS paid those fees to the Sinyards' attorneys, IDS satisfied its own statutory obligation. *Old Colony* is inapposite." 268 F.3d at 762 (McKeown, dissenting).

Again, the situation more closely resembles a disposition of property. If a taxpayer sells stock and pays the broker an agreed percentage of the proceeds, the IRS does not view the payment as the satisfaction of a debt owed to the broker. Rather, broker's commission is subtracted from the price paid to arrive at gross income. Treas. Reg. § 1.263(a)-2(e) (1987). As ATLA argues in Part III, below, similar

treatment is appropriate for fees allocable to personal injury damages.

C. Include-Deduct Tax Treatment Is Not Required To Avoid Favoring Contingency Fees Over Hourly Fees.

The Commissioner's third contention is in the nature of a policy argument: To permit taxpayers to exclude attorney contingency fees from gross income would create "an artificial, a purely tax- motivated, incentive to substitute contingent for hourly legal fees." Brief of Petitioner at 33, quoting *Kenseth, supra*, 259 F.3d at 884.

The Commissioner's concern is on a par with locking the barn door to keep fish from escaping to the river. The truth is that almost no individuals retain an attorney in a nonphysical personal injury case on an hourly fee basis. The reasons for this are legitimate and entirely non-tax related. First, and most important, many individuals simply could not afford to pay for legal representation on an hourly basis. Indeed, it is precisely because many aggrieved persons "cannot afford to purchase legal services at the rates set by the private market" that Congress has enacted fee-shifting statutes. *Rivera, supra,* 477 U.S. at 576.

Second, even if a client can afford to pay by the hour, a contingency fee agreement shifts the risk of loss of the case to the attorney, who is generally better equipped to bear that risk. Third, the contingency fee assures that the lawyer's interests are firmly aligned with the clients: The lawyer earns more not by billing more hours, but by obtaining more compensation for the client. *See* Charles Silver, *Due Process and the Lodestar Method: You Can't Get*

There From Here, 74 Tulane L. Rev. 1809 (2000) (noting a "broad consensus that percentage-based formulas harmonize the interests of agents and principals better than time-based formulas").

In short, taxation of contingent fees to clients will not motivate people to retain lawyers on an hourly basis. Rather, they are likely to abandon efforts to enforce their legal rights altogether. *Rivera. supra*, 477 U.S. at 578.

Nor does Commissioner's policy argument address the tax treatment of court-awarded fees, which are hourly-based and not a matter of the client's choice.

Moreover, the Commissioner has not established that attorney fees paid on a fixed or hourly basis would necessarily be deductible if contingent fees were excluded from income.[9] There appears no reason why such fees could not receive the same treatment. For example, in *Ward. v. Commissioner*, 20 T.C. 332 (1953), the Tax Court held that a fixed fee retainer paid to an attorney in connection with the sale of a partnership is not deductible, but "is to be used as an offset against the selling price just like any other expenditure made in connection with the sale of a capital asset." *Id.* 342

III. DAMAGES RECEIVED ON ACCOUNT OF PERSONAL INJURY ARE PROCEEDS OF A

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9 The Commissioner asserts that the taxpayers here have conceded if they had paid their attorneys on an hourly basis the fee "would have been an deduction from, not a reduction of" gross income. Brief of Petitioner at 25. Commissioner provides no citation to the record evidencing such a concession.

DISPOSITION OF PROPERTY, FROM WHICH ATTORNEY FEES ARE SUBTRACTED AS A CAPITAL EXPENSE.

A. A Judgment or Settlement of a Personal Injury Cause of Action Is A Disposition of Property.

The Commissioner supports the inclusion of attorney fees as income to both the taxpayer the attorney with this analogy: "[W]hen an individual uses a portion of his salary to pay for the services of a plumber, the same income is taxed to both the individual and the plumber." Brief of Petitioner at 34.

ATLA offers a different analogy that is closer to the mark. A taxpayer who wants to sell his or her house may retain the services of a real estate agent on a contingent basis. If the house sells, the agent receives a commission, perhaps 6% of the sales price. As the IRS correctly instructs taxpayers, the gain on the sale is the sales price minus selling expenses, including the agent's commission (and any legal fees). Internal Revenue Service, "Selling your Home," Pub. 503, at 3-4 (2003).[10]

I.R.C. § 1001(a) states that the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis." I.R.C. § 1012 provides that the "basis of property shall be the cost of such property," and I.R.C. § 1016 requires that "[p]roper adjustment

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[10] If the Commissioner's plumber installs a new water heater, that expense is capitalized by adding it to the basis of the property, regardless that the taxpayer used taxable salary to pay the plumber.

in respect of the property shall in all cases be made (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account."

The proper adjustment for recovery of capital expenditures, this Court has explained, occurs through an offset to the selling price, rather than deduction. *Woodward v. Commissioner,* 397 U.S. 572, 574-75 (1970) For example, attorney fees paid in connection with the sale of stock "are an offset against the selling price." Treas. Reg. § 1.263(a)-2(e) (1987).

A vested cause of action is, of course, "a species of property." *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 428 (1982); *Martinez v. California*, 444 U.S. 277, 281 (1980). The Code classifies a cause of action, or "chose in action," as "intangible personal property." As the Internal Revenue Manual explains:

> Intangible personal property includes "choses in action." . . . A chose in action is a personal right not reduced to possession and recoverable by a suit at law. A plaintiff's cause of action in tort against a defendant is an example of a chose in action.

I.R.M 5.17.2.4.3.4 – Intangible Property (2000). *See, e.g., Jeffrey v. United States,* 261 B.R. 396, 401 (2001) (taxpayer's unliquidated medical malpractice cause of action held to be intangible personal property).

I.R.C. § 1001 and its associated provisions are not limited to the sale or disposition of capital assets. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87 (1992) ("creation of a separate and distinct asset . . . not a necessary, condition to classification as a capital expenditure."); *See* Edwin A. Morse, *Taxing Plaintiffs: A Look At Tax Accounting for Attorney's*

Fees and Litigation Costs, 107 Dick. L. Rev. 405, 474 (2003) ("It is important to recognize that "offset" treatment is not limited to situations where capital-gain producing assets are involved.").

In any event, a taxpayer's cause of action is a clearly a capital asset under the Code. Under I.R.C. § 1221, intangible personal property falls within the definition of a capital asset unless it is excluded as being property used in the taxpayer's trade or business that is subject to the allowance for depreciation.

The status of an unliquidated cause of action as property, subject to the tax rules governing the sale or other disposition of property, is evident in this case. Taxpayer Banks purchased his cause of action against DOE from his estate in bankruptcy for $10,000. *Banks v. Commissioner*, T.C. Memo. 2001-048 (Tax Ct. 2001). The Tax Court excluded the $10,000 purchase price from Banks' gross income from the settlement. *Id.*

There remains only the question of whether payment of a settlement or judgment that releases the defendant from liability constitutes a sale, exchange or "other disposition" of property under § 1001. The Commissioner himself suggests the answer is yes, stating that in this case, "the settlement proceeds represent the value given in exchange for the dismissal of respondents' claims." Brief of Petitioner at 12.

For example, in *Siple v. Commissioner*, 54 T.C. 1, 7 (1970), where Siple received $30,000 from Mizner in return for a contingent claim against Mizner and his company, the Tax Court stated that "the transaction involved the sale or exchange of capital assets"

This reflects longstanding practice, even under the more restrictive predecessor sections of the Internal Revenue Code of 1939. In *Herbert's Estate v. Commissioner,* 139 F.2d 756, 758 (3rd Cir. 1943), for example, Herbert's claim against a corporation was paid by the corporation to the estate. In the court's view, Herbert's "estate had a chose in action, property, which it got rid of or relinquished upon payment. . . . We have no doubt that the payment here of the claim held by the estate was a 'disposition' of the claim within the meaning of Sec. 111."

Courts have long viewed the release by one party of the legal obligations of another as a sale or disposition of a property interest. In *Commissioner v. Golonsky,* 200 F.2d 72, 74 (3rd Cir. 1953), the court found it "no longer open to doubt" that choses in action are intangible property and that the release of such a right falls within the broad definition of a sale or exchange of property. Similarly, in *Appalachian Elec. Power Co. v. United States,* 158 F. Supp. 138, 140 (Ct. Ct. 1958), the court agreed with plaintiff that an agreement releasing defendants' obligations under a prior contract was the sale or exchange of a capital asset and "should receive capital assets treatment for tax purposes." *See also Ray v. Commissioner,* 18 T.C. No. 52 (1952) (lessee's release to lessor of a restrictive covenant held to be a sale of a capital asset); *Benedum v. Granger*, 180 F.2d 564, 566 (3rd Cir. 1950) ("Mr. Benedum having held 'property,' a chose in action, exchanged it for other less valuable property. The transaction clearly constitutes an exchange of capital assets.")

In sum, ATLA submits that legal fees in connection with damages on account of nonphysical

personal injury should be treated as capital expenditures and offset against the total recovery to arrive at gross income. Commissioner has pointed to no specific Code provision that would require such fees to be treated as deductions. As this Court has made clear, "deductions are exceptions to the norm of capitalization." *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79, 84 (1992) "[C]apital expenditures, by contrast, are not exhaustively enumerated in the Code. . . For these reasons, deductions are strictly construed and allowed only as there is a clear provision therefor." *Id.*

B. Capitalization of Attorney Fees Does Not Violate The "Source of the Claim" Doctrine.

In Brief for Amici Curiae Professor Gregg D. Polsky and Professor. Brant J. Hellwig, the professors, without discussing capitalization of legal fees in detail, suggest that including only the net proceeds of an award or settlement would do violence to yet another judge-made doctrine, the origin of the claim rule. Id. at 15-16 n.15. Under that doctrine, they state, "the cause of action is disregarded as a separate asset" and the nature of the underlying claim determines the tax treatment of the associated legal expenses. *Id.*

In ATLA's view, this extends the doctrine far beyond its purpose. The "origin of the claim" rule, which this Court first enunciated in *United States v. Gilmore,* 372 U.S. 39 (1963), addresses whether a taxpayer may take a deduction for legal fees as a business expense under I.R.C. § 162, or as an expense for the production or collection of income under I.R.C. § 212. 6 MERTENS LAW OF FEDERAL INCOME TAXATION § 25A:04 (2004). In *Gilmore*, for

example, the Court heid that the husband's legal fees in a divorce proceeding were "personal," rather than business expenses.

However, the doctrine has no application to the antecedent question of whether the taxpayer has income in the first place. The rule is designed to properly classify the legal expenses incurred to secure or maintain the production of income from income producing property. *See* MERTENS, *supra*. But it does not apply to the legal expense incurred in the sale or disposition of that asset. As this Court made clear in *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), "[i]f an expense is capital, it cannot be deducted," under either § 162 or 212. "The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it." *Id.* at 575 & 576.

The professors' fears that, unless this Court adopts the include-deduct treatment of legal fees, the distinction between income and property under the Code would "be effectively eliminated," Brief of Amici at n.15, are overblown. When legal fees for personal injury damages are subtracted to arrive at taxpayer's gross income, the rule remains that the nature of the underlying claim determines whether the taxpayer's income is ordinary or capital gain.

For example, taxpayer Banks in this case paid $10,000 to acquire his cause of action from the estate in bankruptcy. The Tax Court subtracted that $10,000 from the settlement to arrive at Banks' gross income. *Banks v. Commissioner,* T.C. Memo. 2001-048 (Tax Ct. 2001). The is no dispute that if Banks had incurred legal expenses in that acquisition, they would also be excluded from income, as *Woodward*

makes clear. Capitalization of these costs and expenses do not depend upon the origin of the claim. However, the damages paid on account of the claim, by virtue of the proper application of the origin of the claim doctrine, are ordinary income.

There is no persuasive reason, under the Code or in common sense, to treat the legal fees incurred to obtain damages in nonphysical personal injury cases as anything other than a capital expense, offset, under *Woodward*, against the settlement to arrive at taxpayer's gross income.

CONCLUSION

For the above reasons, the decisions of the courts of appeals should be affirmed.

Respectfully submitted,

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